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No. 1015

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

R. C. OWEN COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

R. C. Owen Company, a Kentucky corporation, petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Sixth Circuit in this case (No. 16,018 below).

OPINION BELOW

The opinion of the Court of Appeals (App. A1)[1] is reported at 351 F. 2d 410. The findings of fact and opinion of the Tax Court (App. A9) are reported as T. C. Memo. 1964-120, Dec. 26,788 (M). The order of the Court of Appeals denying petition for rehearing (App. A18) has not been officially reported.

1. References are to the Appendix to this petition, except where otherwise noted.

JURISDICTION

The judgment of the Court of Appeals was entered on October 7, 1965. (Certified record). Petition for rehearing was filed and denied November 19, 1965. (Certified record). The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254(1).

QUESTIONS PRESENTED

1. Whether the "unless clearly erroneous" principle of Rule 52(a) of the Rules of Civil Procedure is applicable on review of a Tax Court decision holding that corporate debentures constituted equity capital, for purposes of the interest deduction under Section 163(a) of the Internal Revenue Code, because of language in the debentures said to give the holders "rights normally enjoyed only by common stockholders."

2. Should corporate debentures be treated as equity capital, for purposes of the interest deduction under Section 163(a) of the Internal Revenue Code, because the holders of three-fourths in amount thereof may, by vote, agree to amend the provisions of the debentures, or accelerate maturity in the event of default, without the consent of the remaining holders?

RULE AND STATUTE INVOLVED

"Rule 52. Findings by the Court.

"(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the ap-

propriate judgment; . . . Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. . . ."[2]

Section 163(a), Internal Revenue Code.

"Sec. 163. Interest.

"(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

STATEMENT

On January 1, 1947, the petitioner acquired, for stock and securities, the assets and business of a family partnership engaged in the manufacture and sale of hardwood flooring and allied products. So that the transaction would be non-taxable under Section 112(b)(5) of the Internal Revenue Code of 1939, the stock and securities exchanged for the business and assets were issued *pro rata*. The stock so issued consisted of 20,000 shares of common stock and the securities consisted of $340,000 of twenty-year 3-1/2% debentures called "Debenture Bonds." R. C. Owen received 72% of each, and each of his two sons, R. C. Owen, Jr. and Roy Owen, received 14% of each. (App. A9-10).

As the result of a decision of the Court of Claims in a case involving a Tennessee corporation having the same name, *R. C. Owen Company* v. *United States*, 180 F. Supp. 369 (1960), involving debentures with similar provisions, the Commissioner of Internal Revenue determined that interest payments on the petitioner's debentures for the

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2. Section 7482, Internal Revenue Code, made this rule applicable to the review of Tax Court decisions, abolishing the standard of review established by *Dobson* v. *Commissioner*, 320 U. S. 489.

years 1954, 1955 and 1956 should be treated as dividends. The Tax Court, in a memorandum opinion by Judge Dawson, sustained the Commissioner's determination on the theory that certain of the provisions in these debentures gave to the holders thereof "rights normally enjoyed only by common stockholders." The opinion of the Tax Court makes it clear that, absent the provisions in question, the decision would have been for the petitioner. (App. A14-16).

There was no question of "thinness" (abnormal ratio of debt to equity capital), and no evidence of intention on the part of the holders of the debentures not to enforce collection. The tangible assets of the corporation always had values very largely in excess of the face amount of the debentures, without any value being attributed to good will. Moreover, substantial dividends (aggregating $195,000) had been paid during the years 1948-1954, inclusive; and during the years 1948-1950, inclusive, an aggregate of $100,000 of the debentures had been redeemed. Interest was always promptly paid, and there was no default of any kind. At December 31, 1956, petitioner's earned surplus was $629,619.19 as against outstanding debentures of $240,000. (App. A11-12).

The provisions of the debentures, which, in the opinion of the Tax Court, gave the holders thereof "rights normally enjoyed only by common stockholders," were (1) that the Company was "authorized and empowered" to make alterations or amendments to the debentures when approved "by a vote in writing of the holders of these Debenture Bonds holding seventy-five per cent of the principal amount thereof," and (2) that, upon default in the payment of interest, or other default, "then and in such event, and after thirty (30) days' notice in writing to the Company of the existence of the default, the holders of

75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such declaration shall mature all outstanding Debenture Bonds, with the same effect as if they had matured by lapse of time." (App. A10-11).[3]

During the years before the Court the ownership of the stock and debentures was as follows (App. A13):

	Shares of Stock	Debentures
R. C. Owen	—0—	$168,000
R. C. Owen, Jr.	5,100	36,000
Roy Owen	5,100	36,000
R. C. Owen, Jr., et al., Trustees[4]	9,800	
	20,000	$240,000

The Tax Court carefully omitted to make a finding of *fact* that the debentures constituted equity capital, rather than indebtedness (because the *extrinsic* evidence supported the taxpayer), but stated its *conclusion* to this effect in an opinion which followed the findings of fact. (App. A14-17). The Court of Appeals nevertheless invoked the "unless clearly erroneous" principle of Rule 52(a). The Court of Appeals misunderstood the facts found by the Tax Court (doubtless because of the long interval between the oral argument and the decision, during which one of the judges who heard the argument became fatally ill) and emphasized in the opinion the Court's belief that peti-

3. The Court of Appeals erroneously believed that, absent this provision, any holder could accelerate maturity upon default. (See footnote to opinion, App. A7).

4. This was an irrevocable trust created December 1, 1947, by R. C. Owen for his six children, including R. C. Owen, Jr. and Roy Owen.

tioner's redemption of debentures had taken place *after* the interest deduction had been challenged by the Internal Revenue Service, and that the payment of dividends had also taken place belatedly. In disposing of a petition to rehear, the Court conceded that an erroneous assumption of fact had been made, but stated that it was not of "controlling importance"[5] in the Court's view that the decision of the Tax Court should be affirmed. (App. A18).

REASONS FOR GRANTING THE WRIT

The Court of Appeals has erroneously invoked the "unless clearly erroneous" principle of Rule 52(a) on a pure question of law: whether debenture provisions authorizing and empowering the corporation, with the consent of holders of three-fourths in amount of the outstanding

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5. This can mean only that the controlling points to the Court of Appeals (as well as to the Tax Court) were the "voting" provision and the acceleration provision of the debentures, although the Court of Appeals did list three circumstances as giving support to what the Court erroneously referred to as the Tax Court's "final factual inference drawn from the evidence." The first of these circumstances was the proportionate holding of stock and debentures at the beginning of the corporation's existence. But the ownership had been completely disproportionate for several years before the taxable years in question. The second was the fact that the debentures "did not come into being as promises to repay a borrowing or as means of providing needed financing of the corporation." The Tax Court correctly held a like circumstance to be completely irrelevant in *Charles D. Vantress*, T.C. Memo., 1964-123, Dec. 26,781 (M), filed May 4, 1964, shortly after its opinion in the instant case, filed April 30, 1964. The third was the fact that, *prior to* (but not during) the years in question, the debentures had been temporarily subordinated to indebtedness to banks and trade creditors. But permanent and more far-reaching subordination provisions have been many times held to be of little significance, e.g., *John Kelley Co.*, 1 T.C. 457; reversed, 146 F. 2d 466; cert. granted, 325 U. S. 843; reversed, *John Kelley Co.* v. *Commissioner of Internal Revenue*, 326 U. S. 531.

debentures, to amend or alter the debentures, and further authorizing the holders of three-fourths in amount to accelerate maturity in the event of default—in each case without the consent of the remaining holders—confer "rights normally enjoyed only by common stockholders." This question should have been decided *de novo* by the Court of Appeals. This Court, in *United States* v. *United States Gypsum Co.*, 33 U. S. 364, 394, said that Rule 52(a) is applicable to "inferences drawn from documents or undisputed facts;" but the holding of the Tax Court was not an inference of fact drawn *from* the debentures, but was a construction *of* their language. Where extrinsic evidence is relied upon to convert instruments in the form of indebtedness into equity capital, the Tax Court habitually makes an ultimate finding of fact to that effect. Here the extrinsic evidence supported the taxpayer; and the Tax Court made no such finding of fact, but "stated separately" a conclusion of law. What the Court of Appeals actually did was to adopt from the Tax Court, under the guise of a "not clearly erroneous" finding of fact, an untenable view of debenture provisions of a kind quite common in the financial world.

If the interest deduction is to be disallowed because holders of a specified percentage of debentures or bonds may, by taking a vote, act for the remaining holders in dealing with the debtor corporation (the so-called "rights normally enjoyed only by common stockholders"), a drastic amendment of Section 163(a) of the Internal Revenue Code will have taken place without Congressional action, and draftsmen of corporate securities may be forced to give up a device of great utility which is expressly sanctioned (with limitations) by 15 U. S. Code, Sec. 77 ppp (Trust Indenture Act of 1939, Aug. 3, 1939, c. 411, 53 Stat. 1172). There are two additional cases pending in the Court of Appeals for the Sixth Circuit, in which debenture provisions substantially identical with those here involved have been held by the Tax Court in one case, and a district court in the

other, to have the same effect given them in the instant case: *Hippodrome Bldg. Co.*, T. C. Memo., 1965-25, Dec. 27,241 (M), and *Fellinger* v. *United States,* (U.S.D.C., N.D., Ohio, 1964) 238 F. Supp. 67. With these decisions to rely upon, the Internal Revenue Service may be induced, unless the present decision is reviewed, to disallow interest deductions on other outstanding corporate debentures and bonds conferring similar voting powers on holders.

Some years ago the Internal Revenue Service made the same contention with respect to similar provisions in debentures containing provisions for temporary relief to the debtor corporation, but the contention was then rejected by the Board of Tax Appeals, and the Board's decision was sustained by the Court of Appeals for the Second Circuit in *Commissioner of Internal Revenue* v. *O.P.P. Holding Corp.*, (2 Cir. 1935) 76 F. 2d 11. We quote from the opinion of the Court the following paragraph, setting forth the contention made by the Commissioner of Internal Revenue:

> "The debenture bonds contain certain unusual provisions upon which the petitioner strongly relies in urging that they should be treated as certificates of preferred stock. They are subordinated, both as to principal and interest, to the claims of all other creditors; and the company may at its option suspend or defer the payment of interest, 'but such suspension of payment shall in nowise relieve the Corporation of the obligation to pay the same at some future time.' It was also provided that the company should pay no dividend upon its stock unless all interest on its debenture bonds should have been paid in full. The bonds had a definite maturity date (unless sooner called), namely, June 30, 1954, although holders of two-thirds of the outstanding bonds might extend the date for all."

There has been no change in the statutory language, and the present Sixth Circuit decision is squarely in conflict

with the Second Circuit decision in the case cited. In the Second Circuit case, holders of two-thirds of the bonds could extend the maturity date for all; in the instant case, it took three-fourths. In the Second Circuit case, the corporation could have other relief without the consent of any of the holders; in the instant case, the corporation could have such relief with the consent of the three-fourths but without the consent of the remaining one-fourth. If the debentures were indebtedness in the Second Circuit case, *a fortiori* they are indebtedness here.

The Court, in the present opinion, says that it would be a "novel debtor-creditor relationship where the creditors, on their own motion,[6] could raise or lower the interest rate, adjust the maturity date, or do anything else they chose." This would, indeed, be a novel, and in our view, not a permissible construction; but even if the debentures were fairly susceptible of such construction, the debtor corporation would nevertheless remain unconditionally obligated to pay unless and until relieved of that obligation, in whole or in part, by the creditors. What is otherwise indebtedness does not become equity capital because of the creditors' unexercised power to forgive. Such power would be inherent if not expressed. And if the creditors had the power to impose *additional* obligations on the debtor corporation, without its consent, the latter would nevertheless remain unconditionally obligated on its *original* promise to pay. Thus the classical test of "indebtedness" is fully met.

This Court, in *Deputy* v. *Du Pont*, 308 U. S. 488, 498, said: "In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume

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6. The Court of Appeals said it was "inclined to feel that as written the amendment power did not require corporate consent," (App. A7) and this was the "novel" aspect commented upon.

that Congress has used these words in that sense." The decision of the Court of Appeals departs from that principle.

CONCLUSION

For the foregoing reasons this petition for certiorari should be granted.

Respectfully submitted,

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No. 16018

United States Court of Appeals

FOR THE SIXTH CIRCUIT

R. C. OWEN COMPANY,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION for Review of Decision of the Tax Court of the United States.

Decided October 7, 1965.

Before WEICK, MILLER and O'SULLIVAN, Circuit Judges.

O'SULLIVAN, Circuit Judge. Petitioner, R. C. Owen Company, a Kentucky Corporation, seeks reversal of a decision of the Tax Court, which sustained the Commissioner of Internal Revenue's disallowance of deductions for interest paid by petitioner in the years 1954, 1955 and 1956 upon its issue of so-called debenture bonds. The Tax Court after making its Findings of Fact and expressing its view of applicable law, concluded as follows:

> "Under all the circumstances, we are persuaded that petitioner's Debenture Bonds do not represent a bona fide indebtedness and we therefore hold that respondent [Commissioner of Internal Revenue] did not err in disallowing to petitioner the claimed deductions for the years 1954, 1955 and 1956 on the ground that the same did not constitute interest on indebtedness within the purview of Section 163(a) of the Internal Revenue Code of 1954."

We affirm the decision of the Tax Court which is reported as T.C. Memo 1964-120, P-H Tax Ct. Mem. 64-120.

Petitioner-taxpayer was organized as a Kentucky Corporation on November 23, 1946, to acquire—and on January 1, 1947, did acquire — the family partnership of R. C. Owen Company, manufacturers of hardwood flooring and allied products, the partners being R. C. Owen and his two sons, R. C. Owen, Jr., and Ray Owen. The father owned a 72% interest and each of the sons a 14% interest in the partnership. In exchange for the business and assets of the partnership, petitioner corporation issued to the partners 20,000 shares of one dollar par value common stock and 20 year 3½% debenture bonds in total face amount of $340,000.00. The stock and debentures were issued to the partners in a proportion corresponding exactly to their interests in the partnership. The debentures were not issued as promises to repay money borrowed by the taxpayer corporation.

The memorandum opinion of the Tax Court sets forth in detail the experiences and conduct of the business of the petitioner corporation following the issue of the debentures and the rearrangement of the interests of the various shareholders. We need not review all of such factual material but quote the following from the Tax Court's findings:

> "Petitioner commenced business on January 1, 1947, with net assets (*exclusive* of the $340,000 in debentures) per books of $307,987.32. Included in these assets were (1) inventories which, although carried at a book value of $193,292.62, had a market value of perhaps twice that figure in consequence of the removal of O.P.A. price controls in November of 1946; and (2) fixed assets (plant and machinery) having a book value of $115,600.17 but a real value, as a result of postwar inflation, of substantially in excess of this figure.
>
> In December, 1947, R. C. Owen, chairman of Petitioner's board of directors, made an exchange with the two sons, giving 2,300 shares of the one dollar par

value common stock to each in return for $2,300 of debentures from each son. By instrument dated December 1, 1947, R. C. Owen transferred his remaining 9,800 shares of stock to trustees for the benefit of his six children. The trust deed was irrevocable, and by it R. C. Owen completely divested himself of voting rights and all other control of this stock. After this transaction, R. C. Owen owned $249,400 of the $340,000 of debentures, but he owned no formal stock whatever. Nevertheless, he continued to serve as chairman of petitioner's board of directors until several months prior to his death in 1961."

During the years following its incorporation, taxpayer timely met all amounts payable upon its debentures and at the time of the Tax Court opinion it had redeemed (after the tax years in question and after the commissioner had challenged the deductibility of the interest on such debentures) $100,000 of its debenture bonds. It had also paid substantial dividends on its common stock.

Among the provisions of the debentures were the following:

"* * * the holder hereof * * * agrees that this Debenture Bond shall be subject and secondary to any and all indebtedness incurred by R. C. Owen Company to banks or to others in the ordinary course of business.

* * *

"Any and all provisions and agreements of this Debenture Bond, insofar as it affects the holders hereof, may be changed, altered, or amended by a vote in writing of the holders of these Debenture Bonds holding seventy-five per cent of the principal amount thereof. To accomplish this, a writing shall be executed signed by at least seventy-five per cent of said holders and filed with the company, and thereupon the company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture

Bonds, with the alterations or amendments as provided in said instrument."

"In the event R. C Owen Company fail to pay interest on this Debenture Bond when due, or commit any other event of default hereinabove set out, then and in such event, and after thirty (30) days' notice in writing to the Company of the existence of the default, the holders of 75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such declaration shall mature all outstanding Debenture Bonds, with the same effect as if they had matured by lapse of time."

R. C. Owen and his sons, R. C. Owen, Jr., and Ray Owen were also partners in an enterprise in Tennessee. In the same year that the petitioner Kentucky Corporation was formed, they organized a Tennessee Corporation, R. C. Owen Company, and transferred to it the assets of their Tennessee partnership theretofore known as R. C. Owen, Manufacturers of Tobacco. As in the case before us, the partners received common stock and debentures in proportion to their partnership interests, 72% going to the father and 14% to each son. Such debentures contained provisions identical to those quoted above. The post-incorporation rearrangement of the holdings of the stock and debentures between the father and sons and other members of the Owen family as to the Tennessee Corporation was substantially the same as in the case of the Kentucky Corporation here involved. In this rearrangement the father, R. C. Owen, while divesting himself of all common shares ended as the owner of upwards of 75% of the debentures issued by the Tennessee company and just less than 75% of the debentures issued by the Kentucky company. In spite of his lack of any formal stockholder's interest, R. C. Owen, continued as chairman of the Board of both companies.

For the years 1953, 1954 and 1955, the R. C. Owen Company of Tennessee paid the interest on its said debentures and took deductions therefor in its income tax returns for those years as "interest paid". Int. Rev. Code of 1939 § 23, Int. Rev. Code of 1954 § 163. The Commissioner of Internal Revenue disallowed such deductions and assessed deficiencies accordingly. The R. C. Owen Company of Tennessee brought suit in the United States Court of Claims to recover the amount of such deficiencies which it paid under protest. The Court of Claims sustained the Commissioner's assessment by its decision in *R. C. Owen Company* v. *United States,* 180 F. Supp. 369 (1960) *cert. denied, R. C. Owen Co.* v. *United States,* 363 U.S. 819, 4 L. Ed.(2) 1516 (1960). Its decision was bottomed upon the view that the debentures did not constitute a true indebtedness of the corporation and that the annual payment to the owners thereof did not constitute deductible "interest paid" within the meaning of the applicable sections of the Internal Revenue Code. It held that the assets exchanged for the debentures "definitely constituted contributions to capital, or capital investments on the part of the partners, rather than indebtedness." 180 F. Supp. 373. Following the Court of Claims decision, the Commissioner of Revenue of Tennessee assessed deficiencies against R. C. Owen Company of Tennessee adding back to "net earnings" the amount that that company had previously deducted for payments on such debentures in computing its Tennessee excise tax. The Supreme Court of Tennessee affirmed the Chancery Court of Davidson County, Tennessee, which dismissed the Tennessee R. C. Owen Company's suit to recover the excise taxes paid after disallowance of the payments made on the debentures. *R. C. Owen Company* v. *Butler,* ..... Tenn. ....., 387 SW(2) 830 (1965). We find no reason to disagree with the Court of Claims or the Tennessee Supreme Court in such de-

cisions. We are not cited to any decision suggesting that the Kentucky courts would take a different view of the character of these debentures than did the Tennessee Court. The fact that the taxpayer corporation in the case at bar declared substantial dividends on its common stock during the tax years involved, whereas no like dividends were paid by the Tennessee company and that after the tax years here involved, the petitioner did repay $100,000 of its debentures do not provide a basis for distinguishing the Court of Claims case from the one before us.

The Tax Court in the case at bar relied on various characteristics of the alleged debtor-creditor relationship to support its finding. They were:

(a) The debentures provided that all or any of their terms "as they affect the holders hereof" could be amended by a vote of 75% of the holders thereof. Neither the Tax Court here, nor the Court of Claims in the case of Owens' Tennessee Company expressed a firm view that such right of amendment could be exercised without the agreement of the corporation, but they did rely on such as a *possible* construction of the provision involved. The Court of Claims merely said that "it might well be contended that [by exercise of the right of amendment] the debentures may be changed at will even to the extent of increasing the interest rate or accelerating the maturity. If such be the case, the holders of the debentures would have almost as much control of the corporation as common shareholders." If it was true that under the terms of these debentures 75% of the holders thereof could have, without corporate consent, amended any of the terms which affected the holders thereof, then indeed these debentures were not evidence of debt, for it would be a novel debtor-creditor relationship where the creditors, on their own motion, could raise or lower the interest rate, adjust the maturity date, obtain or give up security, or do anything else they chose. The taxpayer corporation, however, says that these extraordinary

powers could not be exercised by the debenture holders without corporate consent. Certainly such a reading is not clear from the language that upon an amendment being so made "the company is *authorized and empowered* to execute new Debenture Bonds * * * with the alterations or amendments as provided in said instrument." Although we are inclined to feel that as written the amendment power did not require corporate consent,[1] this is not necessary to our decision, for the very fact of ambiguity in the provision was sufficient with the other evidence to support the Tax Court's refusal to treat these debentures as promises to pay a debt owed by the corporation.

(b) There was originally an exact correspondence of interests between the shareholders controlling the corporation and the alleged creditors holding the debentures. While not of controlling importance such identity of interests was a circumstance properly considered on the question here.

(c) The debentures did not come into being as promises to repay a borrowing or as means of providing needed financing of the corporation.

(d) The debentures were to subordinate to "any and all indebtedness incurred by R. C. Owen Company to banks or to others in the ordinary course of business."

(e) Action by 75% of the debenture holders was necessary to accelerate maturity on default.

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1. It should be noted that following the opinion of the Court of Claims and pursuant to agreement of debenture holders of the Kentucky Corporation the debentures were amended to strike therefrom the two clauses which impressed the Court of Claims as negativing the indebtedness character of the debentures, namely the right of 75% of the holders of the debentures to change their terms "as they affect the holders hereof" and the provision whereby upon default acceleration could not be effected except by a vote of 75% of the holders.

No one of the foregoing circumstances was relied on by the Tax Court as alone destroying the indebtedness quality of the debentures, but the total weight of them gave substantial support to the Tax Court's conclusion. Its final factual inference drawn from the evidence before it will not be disturbed by us unless clearly erroneous, 26 U.S.C. § 7482; Rule 52(a) Fed. Rules Civ. P.; *Commissioner* v. *Duberstein*, 363 U.S. 278, 291.

In our recent decision in *Foresun, Inc.* v. *Commissioner*, ------ F(2) ------ (C.A. 6, 1965) this Court took occasion to say:

> "It is axiomatic in tax cases that transactions between members of a family and family-owned corporations are closely scrutinized. It is also well settled that the substance of the transaction, rather than its form, is controlling. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334; *Gregory* v. *Helvering*, 293 U.S. 465; *Consumers Credit Rural Cooperative* v. *Commissioner*, 319 F.2d 475, 478 (C.A. 6); *Gooding Amusement Co.* v. *Commissioner*, 236 F.2d 159 (C.A. 6), cert. denied 352 U.S. 1031.
>
> '[W]hile numerous criteria may exist as guidelines helpful in making the final factual determination as to the true character for tax purposes of a transaction, no single factor can be decisive.' *Moughon* v. *Commissioner*, 329 F.2d 399, 401 (C.A. 6)."

We are of the view that the evidence in this case substantially supported the Tax Court's factual conclusions and we discern no error of law in its decision.

Judgment affirmed.

(Caption Omitted)

T. C. Memo 1964-120 Filed April 30, 1964

MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON, *Judge*: Respondent determined deficiencies in petitioner's income tax for the taxable years and in the amounts set forth below:

Taxable Year	Deficiency
1954	$4,145.15
1955	4,368.00
1956	4,368.00

The principal issue presented for decision is whether respondent erred in determining that petitioner was not entitled to deductions claimed in each of the years 1954, 1955 and 1956 as interest paid on certain of its securities called Debenture Bonds because the so-called debentures did not represent bona fide indebtedness, and the payments made thereon were not deductible as interest.

FINDINGS OF FACT

Many of the facts were stipulated by the parties. Their stipulation, together with attached exhibits, is incorporated herein by this reference.

R. C. Owen Company (hereinafter referred to as petitioner) is a Kentucky corporation having its principal place of business in Hopkinsville, Kentucky. Its Federal income tax returns for the calendar years 1954, 1955 and 1956 were filed with the district director of internal revenue, Louisville, Kentucky.

Petitioner was organized on November 23, 1946, to acquire, and on January 1, 1947, did acquire the family partnership of R. C. Owen Company, manufacturers of

hardwood flooring and allied products, the partners being R. C. Owen and his two sons, R. C. Owen, Jr., and Roy Owen. The interest of the father in the partnership was 72 percent and that of the two sons was 14 percent each. In exchange for the business and assets of the partnership, petitioner issued to the partners 20,000 shares of common stock of the par value of one dollar per share and $340,000 of 20-year Three and One-Half Per Cent Debenture Bonds, the stock and debentures being issued to the partners in exactly the same proportion as their interests had been in the partnership. Each of these debentures contained the following provisions:

> This Debenture Bond may be called and paid at any time up to and including January 1, 1957, at the price of 101% of principal and all accrued and unpaid interest, and thereafter at par plus accrued and unpaid interest * * *. Interest shall cease on any Debenture Bond, or that part of it called for redemption on the date fixed for redemption * * *.
>
> All Debenture Bonds called and redeemed by the Company shall be cancelled and not reissued.
>
> Until the entire amount of Debenture Bonds of this series are paid in full, R. C. Owen Company covenants and agrees not to mortgage, pledge, or place any lien on any property of the Company to secure indebtedness, other than notes for deferred purchase price of realty or personalty secured by a lien on the property purchased or retention of title of personalty, and that it will maintain net current assets in the amount of $100,000, or fifty per cent of the outstanding Debenture Bonds, whichever amount is smaller. The placing of a lien in violation of this agreement or failure to maintain net current assets as herein provided, constitutes an event of default.
>
> By the acceptance of this Debenture Bond, the holder hereof, for himself and all subsequent holders

expressly agrees that this Debenture Bond shall be subject and secondary to any and all indebtedness incurred by R. C. Owen Company, to banks or to others in the ordinary course of business. This subordination shall cease when surplus equals the amount of these outstanding Debenture Bonds. Any and all provisions and agreements of this Debenture Bond, insofar as they affect the holders hereof, may be changed, altered, or amended by a vote in writing of the holders of these Debenture Bonds holding seventy-five per cent of the principal amount thereof. To accomplish this, a writing shall be executed, signed by at least seventy-five per cent of said holders and filed with the Company, and thereupon, the Company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture Bonds, with the alterations or amendments as provided in said instrument.

In the event R. C. Owen Company fail to pay interest on this Debenture Bond when due, or commit any other event of default hereinabove set out, then and in such event, and after thirty (30) days' notice in writing to the Company of the existence of the default, the holders of 75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such declaration shall mature all outstanding Debenture Bonds, with the same effect as if they had matured by lapse of time.

Petitioner commenced business on January 1, 1947, with net assets (*exclusive* of the $340,000 in debentures) per books of $307,987.32. Included in these assets were (1) inventories which, although carried at a book value of $193,292.62, had a market value of perhaps twice that figure in consequence of the removal of O.P.A. price controls in November of 1946; and (2) fixed assets (plant and machinery) having a book value of $115,600.17 but a real

value, as a result of postwar inflation, of substantially in excess of this figure.

In December, 1947, R. C. Owen, chairman of petitioner's board of directors, made an exchange with the two sons, giving 2,300 shares of the one dollar par value common stock to each in return for $2,300 of debentures from each son. By instrument dated December 1, 1947, R. C. Owen transferred his remaining 9,800 shares of stock to trustees for the benefit of his six children.[1] The trust deed was irrevocable, and by it R. C. Owen completely divested himself of voting rights and all other control of this stock. After this transaction, R. C. Owen owned $249,400 of the $340,000 of debentures, but he owned no formal stock whatever. Nevertheless, he continued to serve as chairman of petitioner's board of directors until several months prior to his death in 1961.

There has been no default in petitioner's Debenture Bonds, as all payments upon them have been made when due. During the years 1947 to 1956 petitioner had the following earned surplus (per books) and paid the following dividends on its common stock:

Year	Earned Surplus 12/31	Dividends Paid
1947	$129,205.68	$ —0—
1948	179,850.07	60,000
1949	227,115.21	20,000
1950	332,435.95	50,000
1951	399,789.91	25,000
1952	431,033.77	20,000
1953	454,394.65	10,000
1954	462,910.09	10,000
1955	546,778.64	1,000
1956	629,619.19	—0—

1. The parties have erroneously stipulated that this instrument was executed in January, 1948, despite the fact that it was dated and witnessed December 1, 1947.

Petitioner has also redeemed $100,000 of its Debenture Bonds as reflected below:

Year	R. C. Owen	R. C. Owen, Jr.	Roy Owen	Total
1948	$29,400	$5,300	$5,300	$40,000
1950	22,000	4,000	4,000	30,000
Totals	$81,400	$9,300	$9,300	$100,000

In 1962, pursuant to agreement of the then holders of petitioner's Debenture Bonds,[2] the debentures were amended in the following manner:

(1) By eliminating the two sentences reading as follows:

"... Any and all provisions and agreements of this Debenture Bond, insofar as they affect the holders hereof, may be changed, altered, or amended by a vote in writing of the holders of these Debenture Bonds holding seventy-five per cent of the principal amount thereof. To accomplish this, a writing shall be executed, signed by at least seventy-five per cent of said holders and filed with the Company, and thereupon, the Company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture Bonds, with the alterations or amendments as provided in said instrument."

(2) By striking the language in the succeeding paragraph reading: "the holders of 75% in amount of Debenture Bonds then outstanding may declare the entire series of Debenture Bonds due and payable by a notice in writing to the Company, and such declaration shall mature all outstanding Debenture Bonds," to read: "the holder of any of said Debenture Bonds then outstanding may declare such Debenture Bonds due and payable by a notice in writing to the Com-

2. Being R. C. Owen, Jr., Roy Owen and the estate of R. C. Owen.

pany, and such declaration shall mature such outstanding Debenture Bonds,".

For each of the taxable years 1954, 1955 and 1956 petitioner deducted as interest expense the sum of $8,400, which it had paid to its debenture holders in those years. Respondent disallowed the claimed deductions on the ground that the same did not constitute "an allowable deduction under section 163 of the Internal Revenue Code of 1954."

OPINION

Section 163(a) of the 1954 Code permits a deduction for all the interest paid or accrued within the taxable year on "indebtedness". The issue to be decided in the instant case is whether petitioner's Debenture Bonds represent such an "indebtedness," or whether they evidence merely a proprietary equity on the part of the former partners. Resolution of this issue depends in general upon all the facts surrounding the issuance of the debentures and in particular upon the provisions of the instruments themselves.

Petitioner's Debenture Bonds are by no means unambiguous documents. While unquestionably they contain *some* of the indicia of debt, they also contain numerous other characteristics which are peculiarly associated with stock. For example, upon their issuance they were subordinated to all other indebtedness of the corporation. Further, a default in their provisions is without effect absent a vote in writing of 75 percent in amount of the debenture holders. Finally, there is the recitation that "any and all provisions and agreements" of the debentures, "insofar as they affect the holders [t]hereof, may be changed, altered or amended by a vote in writing" of such holders "holding 75% of the principal amount" of the Debenture

Bonds. Following notification of a vote for such a change or alteration, "the Company is authorized and empowered to execute new Debenture Bonds in exchange for the outstanding Debenture Bonds, with the alterations or amendments as provided in" the notification.

Debenture bond provisions identical with these were construed by the Court of Claims in the case of *R. C. Owen Company* v. *United States*,[3] 180 F. Supp. 369 (Ct. Cl. 1960) certiorari denied 363 U.S. 819 (1960). Commenting upon the "amendment provisions" of such debentures, the Court of Claims observed:

> At the least, these provisions give certain important voting rights to the debenture holders. Although it may be that the entire provision only empowers 75% in amount of the debenture holders to make changes and alterations with the agreement of the corporation, it might well be contended that, by an affirmative vote of 75% in amount of the debenture holders, the provisions of the debentures may be changed at will, even to the extent of increasing the interest rate or accelerating the maturity. If such be the case, the holders of the debentures would have almost as much control of the corporation as common stockholders.

Of similar import is the case of *Luden's, Inc.* v. *United States*, 196 F. Supp. 526 (E.D. Pa., 1961), involving the question of whether certain debenture bonds issued by Luden's company represented bona fide indebtedness. Contrasting Luden's debentures with those which had been the subject matter of *R. C. Owen Company* v. *United States*, supra, the District Court stated:

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3. Not petitioner herein, but a Tennessee corporation which was organized to acquire and did acquire the assets of a partnership engaged in the tobacco business (the partners having been R. C. Owen, R. C. Owen, Jr., and Roy Owen) in exchange for stock and debentures which for all practical purposes are indistinguishable from those involved in the instant case.

> In comparing the rights of the debenture holders in the case at bar with the unusual rights of those who held the disputed securities in the Owen case it becomes apparent that the rights of these debenture holders are quite pedestrian in character. These debenture holders do not have the right to rewrite the debentures as did the debenture holders in the Owen case, and by that means control the obligor corporation.

We are in complete agreement with both the courts above quoted that "amendment provisions," such as are contained in the Debenture Bonds issued by petitioner herein, give to the holders thereof rights normally enjoyed only by common stockholders. Certainly provisions in a purported debt instrument which grant such substantial rights cast a serious doubt as to whether the holder of such an instrument is in fact a creditor of the issuing corporation.

Likewise, the subordination feature of petitioner's Debenture Bonds denigrates the existence of a debtor-creditor relationship between petitioner and its debenture holders. Petitioner's contention that the debentures were not subordinate during the taxable years at issue (because of an excess of surplus over the face amount of outstanding debentures) lacks relevancy to the crucial inquiry whether, *at the time of their issuance,* they represented true debt or merely a continuing proprietary equity. Moreover, as we see it, an "indebtedness" which is subordinate unless the business prospers (i.e., until such time as earned[4] surplus equals the amount of outstanding debentures) is no indebtedness at all, but rather a classic variety of risk capital.

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4. The evidence establishes that petitioner has only one surplus account—that of "earned" surplus—thus eliminating the possibility that the term "surplus" as used in its debentures could refer to any other type of surplus.

Nor is characterization of these Debenture Bonds as representing risk capital negatived by the factual pattern within which they were issued. The debentures certainly were not given, as is typical, in exchange for borrowed money, but rather appear to be the equity interest of the former partners clothed in the dress of corporate debt.[5] And their standing as indebtedness is further subject to attack because of the substantial identity of interest which existed between the holders thereof and petitioner's formal stockholders. Although it is true that after 1947 R. C. Owen owned no formal stock—he having in that year placed all of his stock in irrevocable trust for his children—it is inconceivable that as trust settlor he would thereafter act as a "creditor" in any way inimical to the stock which constituted the trust corpus.

Under all the circumstances we are persuaded that petitioner's Debenture Bonds do not represent a bona fide indebtedness and we therefore hold that respondent did not err in disallowing to petitioner the claimed deductions for the years 1954, 1955 and 1956 on the ground that the same did not constitute interest on indebtedness within the purview of section 163(a) of the Internal Revenue Code of 1954.

Decision will be entered under Rule 50.

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5. Compare *Kraft Foods Company* v. *Commissioner*, 232 F.2d 118 (C.A. 2, 1956), reversing 21 T.C. 513 (1954), wherein the Commissioner's argument that issuance of the controverted debentures brought in no new capital was rejected on the grounds that this principle could not be controlling "where, as here, the debenture is *unambiguous and contains all the characteristics of a debt instrument.*" 232 F.2d at 126 [emphasis supplied]. As has been pointed out, the debenture bonds involved herein are definitely not "unambiguous" and their resemblance to usual debt instruments is questionable.

No. 16,018

United States Court of Appeals

FOR THE SIXTH CIRCUIT

R. C. OWEN COMPANY,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Order Denying Petition for Rehearing

(Filed November 19, 1965)

Before WEICK, Chief Judge, MILLER* and O'SULLIVAN, Circuit Judges.

THIS CAUSE is before the Court upon the petition of taxpayer-petitioner for a rehearing. The petition correctly avers that there was a factual mis-statement in this Court's opinion viz: that taxpayers redemption of $100,000 of its debenture bonds occurred *after* the Commissioner had challenged the deductibility of interest payments on such indenture bonds. While this Court gave consideration to such erroneous assumption of fact, it was not of controlling importance in the Court's view that the decision of the Tax Court should be affirmed.

NOW THEREFORE, IT IS ORDERED that the petition for rehearing be and it is hereby denied.

Entered by order of the Court.

/s/ Carl W. Reuss
Clerk

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*Judge Miller did not participate in consideration of petition for rehearing.